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Watching the road ahead: Tax planning tips for1998

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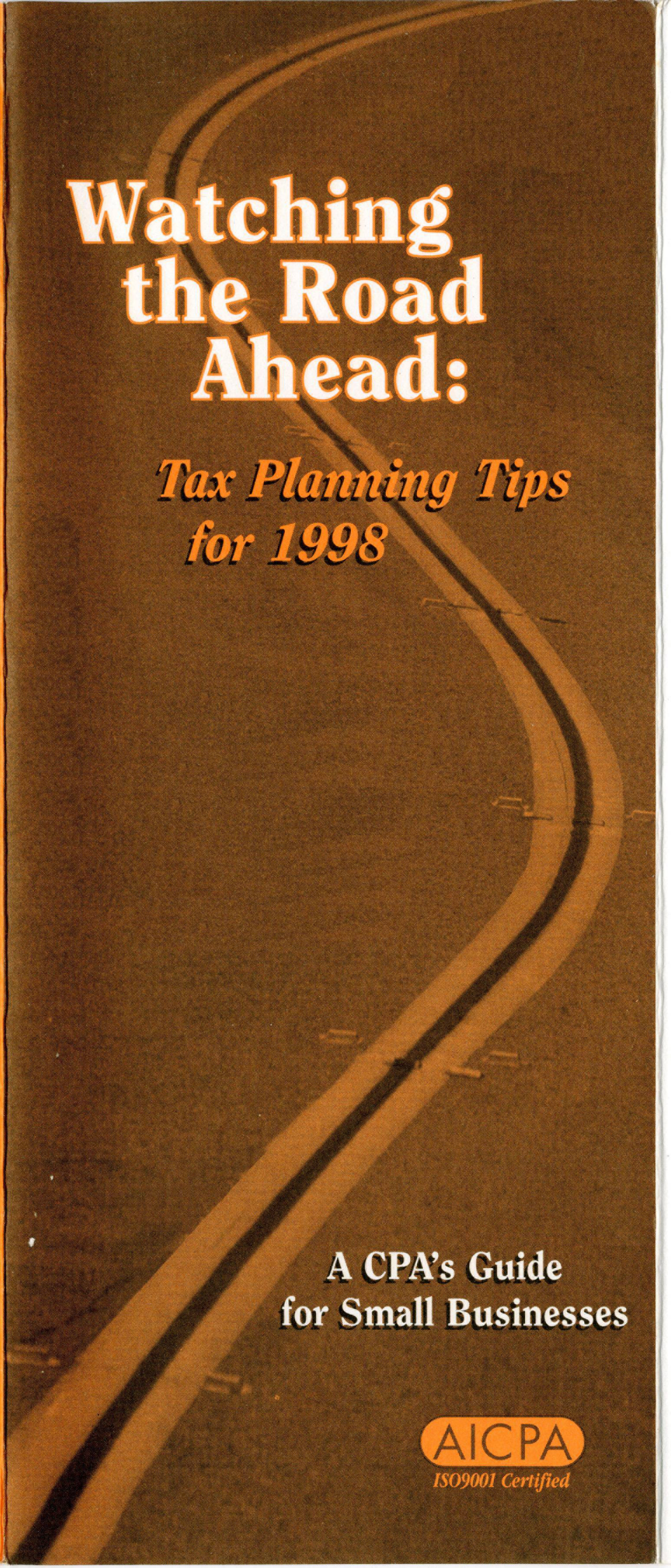

Watching the Road Ahead:

Tax Planning Tips for 1998

A CPA's Guide for Small Businesses

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INTRODUCTION

As a small business owner, you must not only cope with daily responsibilities, but you must take time to plan which direction your business will take in the future. One vital component of your planning should be your yearly tax bill. With some preparation and knowledge, you can steer clear of some common mistakes and take advantage of tax laws meant to help small businesses. This brochure can help you plan by providing practical tax information, tax-savings tips, and the latest tax law changes that might affect your business.

TAX BASICS

Your business' tax bill varies depending on whether its income is taxed at the individual or corporate rate. Individual rates begin at 15%, but may reach 39.6%. Corporate rates are as follows:

Taxable Income	The Tax Rate Is
Over $0 but not over $50,000	15% of the amount over 0
Over $50,000 but not over $75,000	$7,500 + 25% of the amount over $50,000
Over $75,000 but not over $100,000	$13,750 + 34% of the amount over $75,000
Over $100,000 but not over $335,000	$22,250 + 39% of the amount over $100,000
Over $335,000 but not over $10,000,000	$113,900 + 34% of the amount over $335,000
Over $10,000,000 but not over $15,000,000	$3,400,000 + 35% of the amount over $10,000,000
Over $15,000,000 but not over $18,333,333	$5,150,000 + 38% of the amount over $15,000,000
Over $18,333,333	$6,416,666.67 + 35% of the amount over $18,333,333

YOUR TAX IDENTITY

Given the wide range of individual and corporate tax rates, CPAs recommend that you carefully consider how your business is organized. The type of business organization you choose will determine your legal and tax treatment. The basic categories, available in most states, are sole proprietorship, partnership, corporation, and limited liability company (LLC).

Sole Proprietorships and Partnerships. In a sole proprietorship or partnership, business income and losses are "passed through" to the individual owners and are taxed at their individual rates.

C Corporations. A "C Corporation" is the most standard form of corporation, with business income taxed at corporate rates. Under federal and state tax laws, regular C Corporations and their owners are treated as separate taxable entities. When earnings are distributed as dividends, they are taxable to the shareholders at individual rates. For this reason, income from a C Corporation is said to be subject to "double" taxation — once at the corporate rate and once at the individual rate.

S Corporations. An "S Corporation" is a special type of elected tax status in which your business' income and expenses are passed through to shareholders and taxed at their individual rates, whether or not the income is actually distributed. S Corporations are generally not subject to corporate income tax, and distributions usually are not taxable to shareholders. So, income is taxed only once. Keep in mind, though, that S Corporation status carries special eligibility requirements.

Personal Service Corporations (PSCs). PSCs are corporations that provide services in such areas as health, law, engineering, architecture, accounting, and consulting. PSCs operating as C Corporations pay a flat tax rate of 35%, regardless of the level of income. You can also elect to have the PSC taxed as an S Corporation, or convert it to an LLC to change its tax treatment, but check first with your CPA.

Limited Liability Companies (LLCs). Generally, LLCs combine the "limited liability" feature of a corporation with the tax treatment of a partnership. This means that the LLC's income is taxable to the LLC members at their individual rates, and a separate corporate tax is not assessed on the LLC. In most cases, members are not liable for debts and obligations of the business.

TAX-TRIMMING TIPS FOR THE SMALL BUSINESS

Tax Deductions for Compensation for Services. If your business takes a corporate form and your corporate tax rates exceed the individual tax rates, you can reduce overall taxes by compensating yourself and family members for services provided to the corporation. However, the amount of the compensation must be reasonable in relation to the services provided. If the IRS determines that the compensation is excessive, it may disallow the compensation deduction and treat unreasonable payments as nondeductible dividends to the owner. In addition, you should also consider the effect of employment taxes assessed on such wages.

Employment Tax Reductions. Since income distributions to an S Corporation shareholder are not subject to employment taxes, you can pay yourself a reasonable salary and withdraw the excess from the company free of such taxes.

Employee vs. Independent Contractor Status. You may be able to save on employment taxes (as well as fringe benefits) by classifying certain workers as independent contractors, rather than as employees. However, you must know the special rules for qualifying as an independent contractor, as opposed to an employee. You will face stiff penalties and back taxes for misclassifying an employee as an independent contractor.

Retirement Plan Contributions. CPAs recommend that you take advantage of tax benefits associated with qualified retirement plans for your employees. As the employer, you can take current tax deductions for contributions to qualified retirement plans for your employees, and your employees will not recognize taxable income until they withdraw the funds from the plans. Savings Incentive Match Plans for Employees (SIMPLE) is a type of plan with eased reporting and testing rules so small businesses can offer tax-favored retirement programs to their employees.

Deferred Compensation Plans. The use of qualified and non-qualified deferred compensation plans also can provide valuable tax benefits both to you and your employees. Deferred compensation plans allow employees to postpone receipt of part of their current salary to later years. Therefore, if you or your key employees currently are in a high tax bracket, you may want to consider establishing a deferred compensation plan to defer income from high-income years to low-income (such as retirement) years.

Flexible Spending Accounts. Flexible spending accounts provide you and your employees tax savings because the contributions are not subject to federal income or employment taxes. Contributions also may be free from state and local income tax, but generally have to be used by the end of the year or are forfeited by the employee.

Medical Savings Accounts. MSAs are available to small businesses and self-employed individuals who have insurance plans with high deductibles. Both employers and employees can contribute to the accounts, and employee contributions and withdrawals are generally tax-free. Unlike flexible spending accounts, if the money is not spent during the year, you don't lose it at year-end.

Business Property Depreciation. Generally, businesses can elect to deduct immediately up to $18,500 in 1998 of the cost of qualifying property in the year it is placed into service. However, keep in mind that this "immediate expensing" deduction is limited to certain depreciable property used in the business (such as office equipment or machinery) and begins to be reduced dollar-for-dollar once the cost of business property exceeds $200,000.

Travel, Meal, and Entertainment Expenses. If your business routinely reimburses employees for travel, meal, and entertainment costs, make sure you meet the accountable reimbursement plan rules to ensure that such reimbursements will be deductible by your business and that they will not be treated as taxable income to the employee. Business travel expenses are fully deductible, and business-related meals and entertainment are 50% deductible. The rules mandate that the employee submit adequate supporting documentation. In addition, you may elect to pay your employees a "per diem" allowance, in lieu of reimbursing actual travel and meal expenses, as long as the amount does not exceed the applicable federal rate, which varies depending on geographic location.

Donating Overstocks to Charity. Excess overstock, if donated to a qualified charity, can earn your company a federal tax deduction.

Bad Debt Write-Offs. If your business uses the accrual method of accounting, review all outstanding business debts to determine which are uncollectible. If you have outstanding receivables with no chance of collection, write them off in the year they become partially or totally worthless.

The Most Advantageous Accounting Method. One aspect of tax planning you should not overlook is choosing the right accounting method. Generally, taxpayers may choose between the cash and accrual methods of accounting for reporting income and deductions. All taxpayers generally are required to use the accrual method if inventory is a material income-producing factor. Therefore, you should seek the advice of your CPA to determine which method is best (or required) for your business, and, if you currently are using an impermissible one, how to minimize the tax cost of changing methods.

Acceleration of Deductions and Deferral of Income. If you use the cash method of accounting, you may be able to defer recognizing income and prepay some expenses to reduce your current year's tax bill. If you are an accrual-basis taxpayer, however, you generally must report income in the year when the right to the income is secured, whether or not it has actually been received. Likewise, as an accrual-basis taxpayer, you generally will not be able to prepay your expenses. Regardless of what method you use, your CPA can help you make the most of the opportunities that are available.

Estimated Tax Payments. Corporate taxpayers with annual taxable income of $1 million or less may avoid stiff underpayment penalties by making quarterly estimated tax payments of at least 100% of the prior year's tax (provided there was tax owed, and it was a full tax year). However, if your company's taxable income was at least $1 million in any of the last three years and you made estimated tax payments that totaled less than your actual current year's taxes, you cannot avoid the underpayment penalty.

Home Office Deduction. The definition of "principal place of business" has been changed to include a home office that is used by a taxpayer to conduct administrative or management activities of a business, as long as there is no other fixed location where the taxpayer conducts substantial administrative or management activities for that business. This new definition helps those self-employed persons who manage a business from their homes, but also provide a service or meet clients at another location. Remember, however, that the office is deductible only if it is used exclusively, on a regular basis, as a place of business. Taxpayers won't benefit from this new definition until 1999, since it is effective for tax years beginning after December 31, 1998.

Health Deduction for Self-Employed. For those who are self-employed and must pay their own health insurance, 45% of the cost is deductible in 1998.

Estate Tax Exemption for Family Businesses. Previously, there was no exemption for family-run businesses; only the individual unified credit exemption was available. Effective in 1998, when more than 50% of the estate consists of a family-owned business and/or farm, the amount exempt from estate taxes will be $1.3 million (inclusive of the unified credit exemption).

Penalty Avoidance. Making a mistake in calculating your taxes can be quite costly. The IRS may assess a 20% penalty on negligent underpayment, in addition to any taxes that are owed, if you fail to follow the tax rules.

Financial Advice. Even for the smallest of businesses, tax rules can be complex and compliance difficult. CPAs — as highly qualified business and financial advisers — can provide the expertise you need to minimize your taxes and maximize your profits.